Speeches by Bob McTeer

Remarks before the Board of the National Association of Manufacturers
Washington, D.C.
Oct. 4, 2000

It's an honor to be here. When Buddy Holly was 4 years old, he tried to play his toy fiddle in the family band. It made a terrible screeching noise, so his uncle waxed his bow. With his bow waxed, Buddy could play away and not make a sound.

I hope you'll understand that on some sensitive issues, my bow is waxed, especially so soon after an FOMC meeting. We used to have a total blackout for the rest of the week after a meeting, but we're now announcing not only the decision on rates but also what we think the "balance of risks" is going forward—whether they appear balanced or whether they appear tilted toward heightened inflation or economic weakness.

I'll have no comment on yesterday's meeting or decision beyond the official statement released after the meeting. However, since it does reflect the committee's thinking less than 24 hours ago, let me read the relevant parts to you as written—that is, without press interpretation or commentary.

The Federal Open Market Committee at its meeting today decided to maintain the existing stance of monetary policy, keeping its target for the federal funds rate at 6.5 percent.

Recent data have indicated that the expansion of aggregate demand has moderated to a pace closer to the enhanced rate of growth of the economy's potential to produce. The more rapid advances in productivity also continue to help contain costs and hold down underlying price pressures.

However, the utilization of the pool of available workers remains at an unusually high level. Moreover, the increase in energy prices, though having limited effect on core measures of prices to date, poses a risk of raising inflation expectations. The subdued behavior of those expectations so far has contributed importantly to maintaining an environment conducive to maximum sustainable growth.

Against the background of its long-term goals of price stability and sustainable economic growth and of the information currently available, the committee believes the risks continue to be weighted mainly toward conditions that may generate heightened inflation pressures in the future

As you know, the federal funds rate referred to is the overnight rate at which banks lend each other excess reserves on deposit at the Fed. That rate and the discount rate, which is the rate we charge banks that borrow directly from us, are the only rates we influence directly. All other interest rates are determined by private market forces without direct Fed influence.

Sticking to the facts, the committee, from June '99 to this past May, raised the target federal funds rate a total of 1.75 percentage points—to 6.5 percent. Yesterday's "no change" decision was the third such decision since May but also the third in which the balance of risks was seen as tilted more toward heightened inflation than toward economic weakness or a balance of those risks.

Jerry asked me to comment on manufacturing in the New Economy. That's difficult to do without seeming to pander to this audience. But the fact is that the key feature of the New Economy—what we once called the mysterious X factor—is productivity. Or, more specifically, the acceleration of productivity growth since the mid-1990s.

You know very well—but most people don't—that productivity growth has been greatest in the manufacturing sector and slowest in the service sector, although some of that difference may be the result of measurement problems in services.

I've found that the best way to explain the situation in manufacturing today is to relate it to farming yesterday. The big picture is easier to see in agriculture because we're no longer in the middle of the picture. We can now view it with some historical perspective.

The amazing fact is that less than 3 percent of our population now grows more food than almost 90 percent once did. That's productivity growth. Output per farmer grew enormously over the decades, and the sons and daughters of most farmers were freed up to work in the nation's mills and factories. Rapidly growing manufacturing output was added to the still-growing agricultural output to the great benefit of all consumers.

Of course, many people saw only a negative side to this tremendous improvement in output and living standards. They saw the glass as half empty—focusing only on the dark side of productivity growth, the decline of the family farm.

Much the same thing has been happening in manufacturing in recent years. Enormous improvements in productivity have kept manufacturing output growing nicely, with little growth in manufacturing employment. And once again, the half-empty pessimists are missing the forest for the trees. As surging manufacturing productivity frees up labor for our growing service economy—our Third Wave information/knowledge economy—we still hear talk of decline, of becoming a nation of hamburger flippers and a nation making its living by taking in each other's laundry.

It was refreshing to have Jerry ask me to talk about manufacturing in the New Economy—not whether we have a New Economy, but an aspect of the New Economy. Jerry has been ahead of his time in recognizing that "something has changed" and was among the first to see the policy implications of the higher productivity, higher growth, less inflationary economy. I'll summarize that viewpoint as "give growth a chance."

Wanting to test the growth limits of the New Economy is also what I've been about recently. I've been ahead of some people in that regard, but compared with Jerry, I was a day late and a dollar short.

But the good guys are finally winning. We occasionally still see quotation marks around "New Economy," and the term is often preceded by "so-called." But the consensus is growing that "something is different this time," even though those words sound too much like famous last words. Maybe we all exaggerate in debate, but "something is different" is a lot closer to the truth than "nothing has changed." If it's not a new economy, it's at least an improved economy.

But I'm not sure we all mean the same thing by the new labels. Certainly, the distinction made routinely on CNBC, the nerd's ESPN, and other financial shows—the distinction between New Economy firms and Old Economy firms—is a false and misleading distinction. Sure, New Economy firms—the dot-coms—are doing new things. But so are Old Economy firms. Old dogs are learning new tricks.

The churn of creative destruction is going on, not only among firms but within firms as well. I assume all of you have your own version of Stuart, the hyper, crazed guy in the Ameritrade commercial who can show you the new ropes behind closed doors. If not, I recommend your grandkids.

The best, most comprehensive survey of the New Economy I've seen is in the September 29 issue of *The Economist*. Although written by a New Economy skeptic, the article is balanced and fair and a good read. And I sense that the skepticism is slip-sliding away, the author having been mugged by the enormity of what's going on out there. But, as Dennis Miller says, that's just my opinion. I may be wrong.

I see you had Ed Yardeni here yesterday. He's great on the New Economy and has been for years. I'm sorry I couldn't get the Chairman to speed things up so I could come hear him.

The Dallas Fed's best effort at describing the New-Paradigm Economy is in our 1999 annual report, which you can find on our web site, at www.dallasfed.org. Believe it or not, our web site is worth your time. Get Stuart to print you off some of it.

Our annual report essay is entitled, appropriately enough, "The New Paradigm." My own contribution—other than the pictures of me visiting Adam Smith's and Buddy Holly's graves—was to define "paradigm." What exactly does a "paradigm shift" mean? I didn't actually define it, but I described it using the analogy of boiling a frog.

If you want to boil a frog, you don't just drop him in boiling water. He'll jump right out. Instead, you drop him in cool water and gradually raise the heat. The frog won't jump because he doesn't realize his paradigm is shifting.

My new-paradigm frog is becoming famous. Last week, a Wall Street economist—Dick Berner, an excellent economist who is president of the National Association for Business Economics—put out his newsletter with a section titled "McTeer's Frog." Except he turned the tables on me.

My point was that many policymakers were like the frog: they didn't realize the economy's paradigm was shifting and the old rules were becoming obsolete. The shift was too gradual. They didn't notice.

Dick used my frog analogy to suggest that inflation has been creeping up recently, virtually unnoticed. He has a point.

Since "New Paradigm" or "New Economy" means different things to different people, let me summarize what it means, and doesn't mean, to me.

After two decades of extremely slow productivity growth, despite constant advances in information and communications technology and innovation in work processes based on new technology, measured productivity finally started improving dramatically in the mid-'90s. Output per hour worked in the nonfarm economy has at least doubled in the past four and a half to five years—from less than 1.5 percent from the early '70s to the early '90s, to more than twice that in the latter '90s.

During the most recent four quarters, nonfarm productivity grew over 5 percent, raising real GDP growth more than 6 percent and reducing unit labor cost about a half percent. Even so, the growth in overall productivity was exceeded by the growth in manufacturing productivity. Output per hour worked—output growth with a given size and quality of the labor force—is the main source of higher living standards. A doubling of productivity growth cuts in half the time it takes for living standards to double.

I have no idea how much of the recent productivity improvement is sustainable. How much is structural and lasting, and how much is cyclical? Since the surge began almost five years into an expansion rather than at the beginning, I vote for structural. How could it be cyclical when there's been no cycle?

The productivity increase of 1.5 percent, or more, raises the so-called noninflationary speed limit of the economy from 2 to 2.5 percent to 4 percent, or more. Many economists still don't believe 4 percent real growth is sustainable. It may work in practice, but will it work in theory? These doubting economists are mostly from elite universities that don't have good football teams. Being from a jock school, I don't have to tote that load.

If 4 percent-plus growth is not sustainable, then we've been sustaining the unsustainable for almost five years now. At the Mesquite Rodeo, on the edge of Dallas, the buzzer goes off when the rider has stayed on the bull for eight seconds. We've been riding our bull much longer than that.

A higher noninflationary speed limit, of course, implies a lower noninflationary unemployment rate—something economists call the NAIRU, the non-accelerating inflation rate of unemployment, an acronym only an economist could love.

When the noninflationary growth rate was assumed to be 2 to 2.5 percent, the noninflationary unemployment rate was thought to be as high as 6 percent. As growth accelerated and unemployment declined, the presumed NAIRU declined with it—to 5.5 percent, to 5 percent, 4.5 percent . . . .

Well, unemployment has been at or near 4 percent for a while now, and inflation hasn't exploded. But it has crept up a bit over the past year, mostly because of rising energy prices.

One rule of thumb of the Old Economy was the Phillips curve, which posits a trade-off between unemployment and inflation. You can have lower inflation, but only if you accept higher unemployment. You can have lower unemployment, but only if you accept higher inflation. Until recently, we've had declining inflation and declining unemployment at the same time. Either the Phillips curve is dead, or we've been moving backwards on an upward-sloping curve since the mid-'90s. An upward-sloping Phillips curve is just too much to contemplate. I say, let's just pronounce it dead and bury it. I'll visit the grave.

The essence of the new and/or improved economy is faster productivity growth leading to faster output growth with less inflationary impact. Part of the less-inflation part comes from the nature of high tech itself. Moore's law of expanding capacity translates into falling prices for a given capacity. Technology production and deployment are inherently disinflationary, if not outright deflationary.

But globalization also plays a role in reducing the inflationary impact of rapid growth. The collapse of communism and hard-core socialism, the end of the 50-year Cold War, worldwide privatizations and deregulation, the reduction of barriers to trade and investment, the improved efficiency of financial markets, successful anti-inflationary monetary policies, better fiscal discipline. . . all these things pull in a disinflationary direction, partially offsetting the inflationary impact of growing demand.

What does the new paradigm not mean to me? Here we get into a series of red herrings and straw persons. Skeptics say—with great gravity—that we haven't repealed the business cycle and we haven't repealed the law of supply and demand.

Well, duh! Nobody claims to have repealed the business cycle or the law of supply and demand. On the other hand, I can't help noticing that we've had only eight months of national recession since November 1982. That's eight months in almost 18 years. I credit the bar code for much of that improvement, by improving inventory management. Someone should write an ode to the lowly bar code. Not just the bar code, but IT generally has taken much of the uncertainty out of managing production and inventories. Inventories aren't the fundamental cause of recessions, but they usually do trigger them. They're always found at the scene of the crime.

What about repealing the law of supply and demand? Nobody says we have repealed those laws, whatever that means. But the New Economy may have bent supply and demand curves a bit—not broken them, just bent them. New Economy elements have moved the actual economy closer to the perfectly competitive model we studied in Economics 101.

Let me elaborate briefly. When you produce cars or widgets, the first unit is expensive but the second and third units aren't all that cheap either. When you produce software or a new medicine or a movie, the up-front fixed cost is high but subsequent copies are cheap—very cheap. The New Economy features low marginal costs. More long-run cost curves slope downward. Economies of scale are more prevalent. Size and scale matter more, and in the global economy they are more achievable. Size is your friend. But remember, I'm not talking about New Economy firms here. I'm talking about New Economy technology, which is available to all firms. As I've heard Chairman Greenspan say on several occasions, all investment is high tech these days. There is no low tech.

In the new global, competitive economy, the markets are potentially enormous. Maybe not quite winner-take-all, but there's at least an early-bird advantage to being the first to start down the declining long-run cost curve. In most cases, but not all, the early bird gets the worm. But the second mouse often gets the cheese. There's no prize for third. No cigar.

A large part of the New Economy is the network economy. Adding to the network adds value to all past and future network members. While Moore's law says the processing power of a chip doubles every 18 months, Metcalfe's law says that a network's value increases with the square of the number of users. So, let's all get wired.

In an information economy, information and knowledge accumulate and compound. Information is durable. My consumption of information doesn't limit your consumption of the same information. Output doesn't disappear with use. Scarcity, the foundation of traditional economics, is reduced. Reduced, not eliminated.

No, we haven't repealed the law of supply and demand, but we're finding some loopholes. We're flattening out and bending down some supply curves, and demand curves as well. Flatter cost curves mean flatter supply curves, which means that demand growth won't raise prices as much as it did in the past.

That doesn't mean demand can't grow faster than supply and trigger inflation. It can. Inflation is down, not out. There are still limits, but they are higher limits. We just shouldn't base policy on the old, lower limits. And we aren't.

The New Economy is good news—for consumers. That's who economies are for—consumers. All is not so wonderful for producers. Consumers get to participate in the New Economy. Producers have to participate—or lose out.

Increased competition means that producers have to innovate and improve constantly. Monopoly profits are harder to come by. Economic profits are temporary at best, as new producers somewhere on the planet move in like hyenas on someone else's kill. (I've been watching the Discovery Channel.)

As New Economy elements grow and infuse Old Economy firms with new efficiencies and vigor, the churn in the economy—already fierce—will only grow. The choice is between the quick and the dead. Innovate or die. Embrace change. Learn to love chaos. Bringing order out of chaos is an American trait. All of these are. We are the leaders in the New Economy because we nurture our nerds better. Because we aren't as afraid to fail.

Back to manufacturing. Manufacturing firms do not equate to Old Economy firms. Your productivity growth has led the nation's. You've been applying high tech to production for a long time. You know the game. The outside churn won't get you if you let the churn work inside your firms.

People ask me if banking will survive in the New Economy. Sure. It will be different. We may not recognize it. But that's why it will survive. Whatever money looks like years from now, people will still want to rent it. And whatever widgets look like years from now, we'll still want them.

At the rate you're going with productivity improvements through new technology, the factory of the future may have only two employees—a man and a dog. The man's job will be to feed the dog. The dog's job will be to keep the man from touching the equipment.

As Elvis would say if he were here—and who's to say he's not—thank you. Thank you very much.